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Fuld, Leonhard Felix

The principles of securities salesmanship

New York

1920

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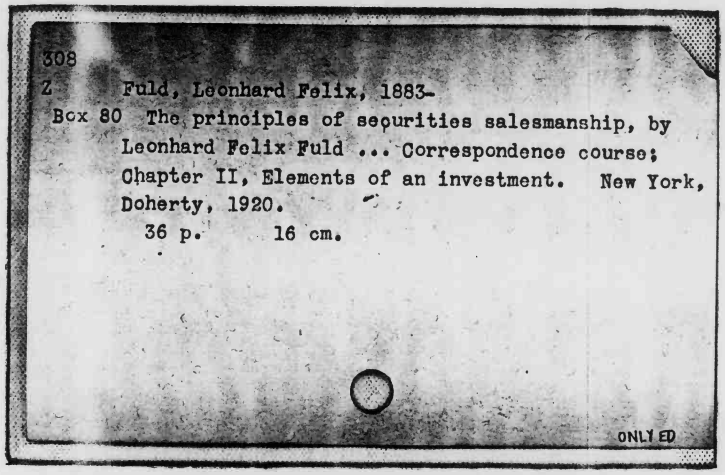
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The Principles of Securities Salesmanship

by

Leonhard Felix Fuld, LL. M., Ph. D.
Director, Doherty School for
Securities Salesmen

CORRESPONDENCE COURSE

CHAPTER II

ELEMENTS of an INVESTMENT

New York
Henry L. Doherty & Company
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CHAPTER TWO

ELEMENTS OF AN INVESTMENT.

Classes of Property.

You have undoubtedly frequently heard that everything which is subject to ownership by an individual is called property, and that all property may be divided into two large classes, real property and personal property.

What is the distinction between real property and personal property? Is property of the greatest value real property? Is a $15,000 automobile real property and a $100 suburban lot personal property? Does real property consist of land, houses and everything connected therewith? Is the picture hung on the wall of your bedroom real property because it is connected with the house? Is the furnace in the basement of your house real property?

Real property consists of land and what is **permanently** affixed thereto. Personal property consists of everything else subject to private ownership. The furnace in the basement of your house is real property, but the picture hanging on the wall of your bedroom is personal property.

In the history of the economic development of the human race real property came first. The gradual development of personal property is clearly reflected in the etymology of certain words of the English language. The word "pecuniary" from the Latin word "pecus," meaning cattle, relates to that stage of economic development when cattle formed the most important article of property. This was

the time when all purchases were paid for in cattle and all sales resulted in the acquisition of cattle by the vendor. This was the period when cattle was recognized as of equal importance with land as an element of property.

The word "expense" from the Latin "expendere," meaning to weigh, shows a further development of the concept of personal property. This word arose in the period when commmodities of personal property were weighed. In this era what was sold was weighed by the seller, who in turn weighed the gold or other commodity which he received in exchange.

The word "money" from the Latin "moneta," meaning a mint, shows a still further development of the concept of property. This word arose in the era when money first came into general use, and money is a value reinforced by a civil guaranty. A coin is a valuable piece of metal which, in addition, carries the guaranty of the government that it is worth the amount stamped upon it.

The most recent development of the concept of personal property is represented by the word "bond" from the French "bonde," meaning a tie. The bond indicates a condition of civilization in which people are willing to trust their money to another on the faith of that other's promise to repay. We find no evidence of this form of property in ancient Greece and Rome, and it seems likely that bonds were first introduced in the Twelfth Century in Venice by the establishment of civil or government loans somewhat

similar to our governmental loans. The concept of the bond was introduced from Venice into France and into the adjacent countries of Europe, until it finally was brought to America where the bond has received its fullest extension and development.

The development of property has been from the clearly physical and tangible ownership of land called real property through the various grades of real and personal property to the ownership of a bond which is personal property, representing a mere promise to pay.

Gambling.

Did you ever gamble? Why did you gamble? How did you gamble? Perhaps by matching coins. Most men and boys have enjoyed themselves at sometime or other in this manner. Did you match coins to make money? If you were honest, this was probably not your only purpose. In matching coins, the result was entirely dependent upon chance and over such chance you had no control. You matched coins for the sport, for the enjoyment which you derived therefrom.

Is it entirely correct to say that you had no control over the result of the matching? We shall leave out of consideration, of course, the fact that if you were dishonest you could have affected the result very materially. Even an honest matcher of coins, however, does exercise some slight control over the result. A man who is engaged in this form of sport

for some time becomes more skillful than a novice. A man who matches coins more frequently has larger opportunities for gain than one who does so infrequently. You have undoubtedly observed these phenomena, even though you have never analyzed them.

Do you know any other forms of gambling besides the matching of coins? How about the purchase of a lottery ticket? Or the acquisition of stock in an oil company owning only wildcat territory remote from any producing land? In both cases the motive is profit as well as sport. In neither case can the result of the venture be foreseen or anticipated. A lucky number may be drawn by the lottery gambler and oil may be struck by the oil gambler. Both are undoubtedly gamblers.

Gambling when honestly conducted is an activity engaged in for sport or for profit, in which wealth is risked on an event over which a person has no control (other than that which results from a knowledge of human nature and from the mathematical law of probabilities) and the favorable outcome of which can neither be foreseen nor anticipated with reasonable assurance.

Speculation.

What is meant by speculation? How does it differ from gambling? When a man speculates, does he do so for the fun he gets out of it or for the profit he makes? Are the risks greater in gambling or in speculation? Does the public derive

any benefit from gambling? Does the public derive any benefit from speculation?

Have you ever speculated? How did you speculate? Did you buy something with the hope and expectation that you could sell it at a later date at a higher price? Is there anything morally reprehensible in such a course of conduct? Perhaps you bought a house with the intention of occupying it and with the hope that the increase in realty values would enable your children to sell it at a profit. Perhaps you bought a Preferred stock with the intention of enjoying your quarterly dividend, and selling the stock at a higher price than you paid for it when the prosperity of the company boosted the price of the stock. Perhaps you opened a grocery store and made yourself responsible for the monthly rent and for the cost of the groceries that you purchased from the wholesaler, in the hope that you would be able to recruit a desirable clientele to whom you could sell your groceries at a higher price than you paid for them. Perhaps you purchased stock in an oil company owning leases on land surrounded by territory already producing oil with the reasonable expectation that this company will also bring in some producing wells.

The desire to speculate is a normal healthy human instinct. There is nothing reprehensible in speculation. If you purchase a lottery ticket for $10 and receive neither interest on the money you have paid nor a promise of its return, but only a chance to win a drawing of $10,000 if

you are lucky, such gambling is morally reprehensible. If, on the other hand, you purchase a Preferred stock paying 6% dividends at seventy-five cents on the dollar in the hope and expectation of receiving, in addition to your $6 of dividends each year, a hundred cents for each seventy-five cents that you have invested in the stock, there is not only nothing reprehensible in the transaction, but you are a shrewd and sagacious business man well on the road to following Rothchild's prescription for getting rich, "to buy cheaply and to sell deal".

Speculation is a business transaction in which a person seeks primarily the enhancement of his principal investment and is willing to assume a risk for the accomplishment of this end.

Investment.

What is the difference between speculation and investment. Does the purchase of stock constitute speculation, and the purchase of bonds investment? If you buy bonds of a moribund corporation in the hope that it will get a new lease of life, is that investment? If you buy a Preferred stock of Cities Service Company with its large assets behind this issue of stock, is this a speculation?

If the kind of security purchased is not the best method of distinguishing between speculation and investment, is the degree of risk assumed a better guide? Is the purchase at a discount of the bonds of a newly organized corporation speculation?

And the purchase of a Preferred stock of a well-established corporation such as the Standard Oil Company, an investment? Is the operation of a corner grocery store or any similar business an investment or a speculation? What is life itself? And are the activities during life investments or speculations?

May a person speculate only by purchasing stock on margin or may a person speculate also when he buys it outright and pays for it in full.

Is the term material in determining whether a security is an investment or a speculation? Are short term securities a speculation and long term securities an investment? What are short term notes, a speculation or an investment?

Which brings the larger return in the long run, investment or speculation? By which process is wealth more rapidly amassed, by investment or by speculation? Does the fact that dividend rates are larger than interest rates prove that a man receives more money in the form of dividends than in the form of interest? How about the reduction of dividends and the passing of dividends during lean years while interest payments are met? Is the fable of the hare and the tortoise applicable to investment and speculation? Do eras of investment and speculation follow each other in chronological cycles?

An investor is one who, without actively participating in the management of an enterprise, devotes his wealth thereto with a view to obtaining continuity and security of income return therefrom with or

without enhancement, while a speculator is one who, either with or without active personal participation, devotes his wealth to an enterprise with the hope of increasing his wealth by the enhancement of his principal and is willing to assume a risk for the accomplishment of this end.

Security of Principal.

When your friend Seymour Morgan asks you for a loan of $100, to what subject will you give most consideration before making the loan? Seymour's ability to pay the interest on the loan? The rate of interest which he is willing to pay? Whether you can sell Mr. Morgan's note for this amount? Whether you can pledge this note with your bank as collateral for a loan? Whether you will be obliged to pay any taxes on this loan? Whether you will have to watch this loan closely? For what period of time Mr. Morgan will keep this money? Whether Mr. Morgan will give you one note for $100 or ten notes for $10? Whether Mr. Morgan will repay you when the note becomes due more than the sum lent with lawful interest? Or are you principally concerned with the certainty of getting your money back at a specified date?

When you buy a share of stock, or a piece of real estate, or a British Consol, when does the man from whom you make this purchase contract to repay to you the purchase price? When does a British Consol become due? When does a share of stock mature? When is a piece of real estate converted into money? In the case

of an investment, which is not a loan, there is no date of maturity, and hence no security of principal in the narrowest sense of that term, which is the certainty of the return of the money at a specified time.

As a depositor in a bank, which places you in the position of a lender of your money to the bank, you can get your money back at any time that you demand it. As the beneficiary of a life insurance policy, you are certain to receive your money when you become entitled to it under the terms of the policy. As a mortgagee of real estate, you will receive your principal when the mortgage becomes due. As the holder of a bond or note, you will be paid on the date of its maturity.

But, though a share of common stock, like other non-loan investments, has no date of maturity, it may and very frequently does possess undoubted security of principal when that term is used in a broader sense. In the case of a share of stock, a purchaser can secure the return of his principal by finding another buyer for the stock he has purchased. If the corporation is prosperous and the share of stock represents adequate assets over and above the liabilities of the corporation, the holder of such stock will experience little difficulty in finding a buyer for it and in recovering his principal investment in this manner.

Security of principal in its narrow sense means the certainty of its return to the investor at a specified time, which is known as its maturity, and in its broader sense the certainty of its return to the investor

through the medium of a re-sale at such time as the investor may elect to make such a re-sale.

Stability of Income.

If you permit your friend Seymour Morgan to occupy a room in your house, you are entitled to charge him rent for the use of this room. If, instead of permitting him to use a room in your house, you permit him to use some of your money, you are also entitled to rent which in the case of money is called interest.

When is interest paid? Is it always paid annually or semi-annually, or quarterly, or monthly as it accrues? Is there any way in which you can be absolutely certain that you will receive your rent? May it be paid in advance? Discount is interest paid in advance. Since the discount is paid at the time the lender parts with his money, it is the most certain form of money rental. Is interest ever paid at uncertain intervals? May a borrower agree to pay interest only if he earns it? This is exactly what takes place when an income bond is issued. Such a bond pays its interest only when, if and as earned.

Is there any necessary correlation between security of principal and stability of income? If your principal is absolutely safe, will this investment also possess necessarily high stability of income? If you hold a $2,000 mortgage on a $10,000 house, this investment possesses great security of principal. You are also reasonably certain of your income. If your income is not paid, you can foreclose the property and the margin of equity, $8,000,

is so large when compared with your investment of $2,000 that only under the most extraordinary circumstances can you lose any portion of your income.

But is certainty of income the only factor of stability of income? You may succeed in obtaining 6% on a real estate mortgage at present. How long will you continue to receive 6%? The mortgage will become due in three or five years. Will you be able to obtain an investment yielding the same interest rate at that time?

You are reasonably certain of obtaining your interest, we have said. Suppose the owner of the property should die or should become suddenly ill, or should become temporarily financially embarrassed, or should forget about paying you the interest. It is true your interest will ultimately be paid to you, and it is likely that the owner will be obliged to pay you interest on your interest, perhaps also some penalty for his neglect. But what will you do in the meantime? Can you say to your landlord, and to your butcher, and to your grocer, when they wish to collect their bills from you, that you are certain ultimately to obtain your interest on the mortgage which you hold? How long do you think your debtors will be willing to extend credit to you on this basis, and if you are evicted from your home and unable to obtain credit at your dealer's, of what avail will the certainty of your securing money at some remote future date be to you?

Real estate and income bonds pay an

income only when they earn it. The income may be certain, but it always lacks uniformity and it may lack promptness. Real estate mortgages are certain to pay their interest if the security behind the mortgage is ample. But such mortgages are of short duration, and you have no assurance that you will be able to obtain a mortgage paying as high a rate when your present investment matures, and furthermore, the owner of the house, being frequently a private individual, may forget to pay his interest when due, or may be prevented from paying it by loss of health, of money, or of life itself. If your money is deposited in a savings bank, your interest will be paid promptly and with certainty, but there is no assurance that your income will be uniform from year to year, because the interest on savings bank deposits may vary from year to year. But if you purchase a long term bond, you will be assured of an income which will be paid to you with certainty at each interest period, which will be paid to you promptly as it becomes due and which will be uniform throughout the entire term of the bond.

What can you do if the interest on a bond is not paid? The Russian government recently defaulted on its 6½% bonds. What are these bondholders doing? Their only remedy is to wait until the American government, by means of diplomatic representations, is able to secure for these bondholders the money which they have lost. What can a bondholder do if the United States government should default on one of its bond issues? Since the

United States government cannot be sued in any court except by its own consent, the bondholder can obtain relief only by Congressional action. What remedy has a bondholder if one of the American states should default on its bonds? Under the United States Constitution, no individual can sue a state, and a state can be compelled to pay its bonds only if another state should purchase them and then bring an action in the United States Supreme Court to enforce such payment against the defaulting state. What is the remedy of a bondholder if a municipality in America should default on its obligations? A municipality may be sued by a bondholder and a judgment obtained, but a bondholder is generally unable to levy execution against the property of the municipality since most municipal property is exempt from attachment on execution. The bondholder has his remedy, however, by an action in the United States courts to compel the proper municipal officials, under penalty of imprisonment, to levy the tax necessary for the payment of the principal and the interest on the municipal bond. Of course, municipal officials may prefer, and in the history of the United States they have actually preferred, to spend their terms in jail rather than vote for the payment of a municipal obligation. Civil credit and municipal credit in the United States is very high, however, because of the high character of the American public conscience and the self-interest of the state or municipality in meeting its obligations, with a view to retaining its credit in the future.

When there is a default in a bond secured by mortgage, or by pledge of collateral, the mortgaged property may be foreclosed, or proceedings may be taken against the collateral pledged under the indenture. In the case of a corporate debenture which is not secured by the pledge of collateral, the bondholder's only remedy is an action against the corporation issuing the debenture, and the issue of execution against that Company's property after a judgment has been obtained. Bankruptcy proceedings may also, in a proper case, be instituted against such a defaulting corporation.

An investment possesses stability of income when there is certainty, uniformity and promptness in the payment of the rental value of the principal loaned, and there is no necessary correlation between security of principal and stability of income.

Income Return.

Is the income return larger on an investment with undoubted security of principal, or on an investment, the security of principal of which is open to doubt? Does a corporation which enjoys excellent credit pay a higher rate of interest than one, the credit of which is not as good? May the securities of a company, enjoying the best financial rating, be purchased ordinarily more cheaply than those of a corporation enjoying only second rate or third rate financial rating? Is the term "income return" synonymous with the term "interest rate?" Or does it involve an additional concept? Does the income return always

vary inversely with the security of principal, or are there other factors involved in this investment problem?

What determines the income return of an investment? The first factor is undoubtedly the interest rate. Other things being equal, a $60 coupon on a 6% $1,000 bond brings a larger income return than a $50 coupon on a 5% $1,000 bond. Under what circumstances may the $50 coupon bring a larger income return than the $60 coupon? Obviously, if the 5% $1,000 bond was purchased so cheaply that the $50 is more than 6% of the purchase price. In addition to the interest rate, the purchase price of the investment must be considered in determininig the income return. The term or duration of the investment is a third factor.

How is the price of an investemnt determined? You will answer that it is usually determined by the demand for the investment. How is this demand determined? Do you think it is determined wholly by the relative merits of the various investments? Or is it determined rather by the knowledge of investors regarding the relative merits of these investments? If the latter statement is true, an investor with greater knowledge of the relative merits of investments will be able to pick up real bargains in the investment field.

Are there any investments which bring a sub-normal or less than fair income return? Why are United States Government 2% bonds usually at a premium? Why does annuity insurance bring such a very small income return? Why do the bonds of the United States Postal Savings

system bring such a very small income return? In the case of annuity insurance and in the case of Postal Savings bonds, it is due to the fact that there are so many people wholly ignorant of financial matters who insist upon investing their money in a manner which they know to be absolutely safe, irrespective of the amount of the income return. In the case of the United States Government 2% bonds, the subnormal income return is due to the abnormal demand for these bonds on the part of the National Banks who are required by statute to use them as security for the issue of notes having the circulation privilege.

Are there any investments which have a super-normal or more than a fair income return? Are the only securities which have a supernormal income return those regarding which there is in the minds of investors, either justly or injustly, grave doubt of the repayment of the principal at its maturity? Such investments undoubtedly bring a supernormal income return, firstly, because there are comparatively few people willing to put their money into investments of this class and, secondly, because such a supernormal income return is necessary to attract capital for investment in them. Is a supernormal income return comparable to a red light on the railroad, or is it only a yellow light? In other words, is it a danger signal to the investor, or is it only a cautionary signal? May investments with undoubted security of principal yield a supernormal income return? How about municipal bonds of comparatively small cities for which there is

no intensity of competitive demand? How about the smaller public utility issues about which the general investing public knows little, but which are frequently far safer than the issues of the larger public utility corporations in the large centers of population which enjoy greater intensity of demand? How about newly issued securities which lack seasoning, but which to the discriminating and astute investor show great security of principal and most of the desirable investment elements?

The income return which is based upon the interest rate, the duration and the purchase price of an investment usually varies inversely with the security of principal; a supernormal income return is not a danger signal which should check every investor, but only a cautionary signal which may be disregarded by any investor possessing sufficient technical knowledge to enable him to determine that the supernormal income return is not due to any cause impairing the security of the investment.

Marketability.

When you purchase an investment, what is your purpose? Do you buy it with a view to selling it, or do you buy it with the intention of keeping it? If you buy it to resell it, are you a speculator? If you buy it to keep it, are you an investor?

But you may think although you purchase the investment with a view to keeping it, you may find it necessary to convert it into money in an emrgency. You will feel easier if you know that you can so convert it. How much marketability or

convertibility do you seek in your investments? Most people seek very much, more in fact than they need. What is the inevitable result of this greater demand for readily marketable investments? A higher price and a lessened income return, necessarily.

What form of investment with which you are acquainted possesses the highest degree of convertibility? Where can you put your money and be assured that you can get it back without any loss at any time that you may need it? A savings bank book is probably the only investment possessing such a high degree of convertibility. Its income return, however, is very small. You should not be satisfied with such a small income return.

Which is more marketable, which is more convertible into money, a bond or a mortgage? Have you ever tried to sell a gilt-edged mortgage? There was no question about its being an absolutely safe investment with a high income yield. Why could you not readily sell it? The first man to whom you applied did not have enough money to buy it. The next man had more than enough money to buy it, and was unwilling to divide his fund in this way. The third man did not know the locality in which the mortgaged property was situated. The fourth man said he might need his money before the mortgage became due. The fifth man said he did not wish to be troubled to reinvest his money when the mortgage became due in two years. The next man said he would

be obliged to charge you what you considered an unconscionable sum, for his expenses in making certain that the owner of the mortgaged property had a clear title to it.

What determines the marketability or convertibility of an investment? Are large issues always more easily marketable than small issues? Is such marketability or convertibility determined entirely by the demand for the investment? What is meant by the demand? Is it how often people seek this investment? Is it how safe they regard it as an investment? Is it how many people seek it as an investment?

Marketability, which depends upon the size of the issue, and the activity, strength and breadth of the demand for it, may be obtained only at the price of lessened income return.

Collateral Value.

What is meant by collateral? Is the use of this term confined exclusively to Wall Street? Did you ever ask a friend to leave something of value with you when you accommodated him with a loan? What he left with you as security was collateral.

What determines the collateral value of an investment? Why does a bond possess more collateral value than a mortgage? If somebody applied to you for a loan, and you asked him for collateral, why would you prefer a United States Government bond to a very well secured mortgage with ample equity on a suburban residence? Would it not be because United States Government bonds are more widely known

to you and to everyone else than this particular mortgage? Most collateral is offered to banks and banks are influenced by the same considerations in the acceptance of collateral as you would be.

A real estate mortgage is a simple investment, and every mortgage is a semi-private transaction, the details of which are generally known only to the parties in interest. These details may be ascertained by an outsider, but usually there is considerable expense involved in their ascertainment. In the case of bonds, on the other hand, which are investment securities, their terms, their duration, their protective features, and all of their other details are more or less public property from the reports filed in the stock exchanges, or if the bonds are not listed, from the reports of the investment house which fathered the issue.

The collateral value of an investment, which is its value as security for a loan, is determined by the same factors which influence its marketability or convertibility.

Tax Exemption.

What is meant by tax exemption? Is it possible for any wealth to escape taxation? Or does the term "tax exemption" refer to freedom from direct imposition of a particular tax rather than to exemption from taxation? How many taxing authorities have we under our American system of government? There are Federal taxes; there are State taxes; there are local taxes. Are these various taxes similar or dissimilar? Which is more heavily taxed, investment or speculation? Is the

stockholder more heavily taxed or the bondholder? That the bondholder is more heavily taxed than the stockholder in America leaves no room for doubt.

What is meant by the Tax Free Covenant in a bond? Is this term synonymous with the term "a tax exempt bond"? In the case of the tax exempt bond, no tax is imposed on the bond or on the bondholder. Is a bond with a tax free clause in the same favored position? Or does the tax free clause shift the burden of paying the tax from the bondholder to the obligor which issued the bond? If the burden of paying the tax is so shifted, how is this effected, and how much of the tax burden is shifted in this way? When you collect bond interest through your bank, you are obliged to file an ownership certificate under the Federal Income Tax Law. These income tax certificates are of three colors, yellow, white and green. We may disregard for the present the green certificate which relates to the interest on foreign securities.

What is the purpose of and what is the difference betwen the white and the yellow certificates? When you file a yellow certificate, you claim to be exempt from the imposition of the Federal Income Tax on the ground that the income which you are collecting does not exceed the amount which is allowed you by the Government free of tax. When you file a white certificate, you state that the interest which you are collecting is subject to the Federal Income Tax. If the investment for which you file a white ownership certificate has a tax free clause, the filing by you of a

white certificate will transfer the burden of paying the tax from you to the obligor who has assumed the burden of paying this tax when the investment was issued. Do the obligors generally assume the burden of paying the entire Federal Income Tax, irrespective of its amount? You doubtless know that the normal Federal Income Tax varies from year to year, and that, in addiiton to the normal Federal Income Tax which every citizen must pay, there are graduated surtaxes payable by those with very large incomes, the rate of the surtax depending upon the size of the taxpayer's income. Does the obligor, under a tax free clause, agree to pay a 2% normal income this year, and perhaps an 8% normal income next year? Does such an obligor agree to pay a 10% surtax in the case of one taxpayer and a 50% surtax in the case of another? If this is what the tax free clause means, it would impose a very serious burden upon the obligor. Does the Federal Income Tax permit the assumption of the taxpayer's entire tax burden in this way? It does not. There may be paid by the obligor in this manner directly to the government only 2% of the taxpayer's normal Federal Income Tax. If the normal Federal Income Tax in any year exceeds 2%, the taxpayer must himself pay the excess to the government. The taxpayer must pay his entire surtax, whatever it may be, directly to the government. And even the 2% normal Federal Income Tax, which is paid to the government by the obligor under a tax free clause, must be reported by the taxpayer on his income tax return with a claim of suitable credit for

its payment by the obligor.

The bonds of the various states, of municipalities and of other political subdivisions of the states are exempt from all Federal taxation. What is the reason for this? Is there any statutory provision on the subject? If there is not, how do they come to be tax exempt? What would happen if they were not tax exempt? If the United States Government could levy a tax of 2% on the income derived from municipal bonds, could it not levy a tax of 50% or of 100% on the income of such bonds? Is not the power to tax the power to destroy? In that case, could the United States not prevent a state or a municipality from raising money by means of bonds by the exercise of this taxing power? Such an exercise of the taxing power would be the end of our Federal form of government, and to prevent the destruction of our form of government the courts have held that the United States Government cannot tax the bonds of states or of municipalities, and similarly the states cannot tax the bonds of the United States Government, or of any instrumentality of the United States Government.

Is the difference in the price between a taxable and a non-taxable investment as great as the amount of tax which is levied upon the investment? If it is not as great, this phenomenon can be explained only by the circumstance that the tax laws of the various states are frequently unenforced.

Tax exemption is the freedom which an

investment enjoys from the direct imposition of a particular tax, and such tax exemption while increasing the price of an investment generally does not increase it as much as the amount of the tax imposed.

Care.

Does an investment require any care after it has been acquired? What did you do with your Liberty Bond after you received it? Did you hide it under a vase on your mantle or place it in the innermost recess of a cabinet or bureau in your home? You doubtless know that these are the places first searched by the burglar who visits your residence, and that burglars have a particular liking for Liberty Bonds and other investments in coupon form. Coupon bonds are payable to bearer and any thief can sell them without much difficulty.

Do you know that the United States Government will exchange, free of charge, a coupon Liberty Bond payable to bearer for a registered bond, the principal and interest of which will be paid by check to you and no one else? Do you know that many companies issuing bonds furnish the same service to their bondholders? A coupon bond requires much physical care because if it is lost or stolen, the investor has little chance of retrieving his loss. A registered bond requires little physical care because a finder or a thief of a fully registered bond cannot collect the principal or interest, and the owner of the bond may replace the lost or stolen bond upon compliance with certain conditions necessary for the protection of the true owner

and of the obligor.

Is the holder of an investment called upon to exercise any care other than physical care of his investment? The creator of wealth is a business man who is well able to care for his business affairs. Many investors, on the other hand, are beneficiaries without business experience. They are frequently the improvident and the helpless among us, such as the widow, the orphan and the cripple in mind or body. If the investor is called upon to exercise much proprietary care over his investment, he frequently lacks the knowledge and the experience required for the exercise of this important function.

What proprietary care is required in the case of a depositor in a savings bank? None whatever. The bank exercises all necessary proprietary care. But this freedom from care in the case of a savings bank deposit is largely counterbalanced by the case with which the depositor may withdraw his savings. And once the savings have been withdrawn, the depositor may do with his money what he pleases. Frequently what he does with his money is to squander it.

Is the holder of a real estate mortgage called upon to exercise much proprietary care? What may happen if he fails to exercise such care? Will the accrual of unpaid taxes affect his mortgage? Will depreciation in the value of the property affect him? Will the deterioration of the mortgaged premises affect his security? Need he bother about the adequacy of the fire insurance on the mortgaged property? Is the owner of real estate an investor or

investment enjoys from the direct imposition of a particular tax, and such tax exemption while increasing the price of an investment generally does not increase it as much as the amount of the tax imposed.

Care.

Does an investment require any care after it has been acquired? What did you do with your Liberty Bond after you received it? Did you hide it under a vase on your mantle or place it in the innermost recess of a cabinet or bureau in your home? You doubtless know that these are the places first searched by the burglar who visits your residence, and that burglars have a particular liking for Liberty Bonds and other investments in coupon form. Coupon bonds are payable to bearer and any thief can sell them without much difficulty.

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a business man from the point of view of the amount of care which he is called upon to exercise?

Is the holder of a bond or of stock called upon to exercise more or less care than the holder of a real estate mortgage? If the bond is issued under a trust indenture, will the trustee exercise for the bondholder all necessary care? If the obligor violates any of the provisions of the trust indenture who will enforce them? If the obligor defaults in the payment of interest, does the bondholder need to take any action or will the trustee attend to the necessary legal proceedings?

In the case of investments, registration relieves the investor from physical care, and the proprietary care required varies inversely with the security of the investment and the adequacy of the trust indenture.

Term.

If you were about to make provision for a beneficiary under your will, would you invest your money in short term or in long term securities? If you decide to put your money in long term securities, would you be induced to do so primarily by the consideration that after your death you would be unable to reinvest the funds? Would you do so with a view to safeguarding your money from unwise expenditure on the part of the beneficiary, or on the part of the trustee?

Would you favor long term investments during your lifetime as well? Having made an investment once, you would have

no further care with reference to the possible reinvestment of the funds. Your income would remain the same from year to year. Would this be an advantage or a disadvantage? Does the purchasing value of the dollar remain the same? Will an income of a $1,000 this year be worth as much to you as it was ten years ago?

Long term investments are considered preferable for testamentary purposes and short term investments are considered by many preferable for other purposes, because they permit of reinvestment, with a view to readjusting the investment to the fluctuating purchasing power of the dollar.

Denomination.

What is the usual or normal denomination of a bond? Are bonds usually obtainable for less than $1,000? They are not. Are stocks usually obtainable in amounts of less than $1,000? They are. Most stocks have a par value of $100 a share, and many have even a smaller par value or no par value at all. Under these circumstances should the small investor put his money in stocks rather than in bonds?

Where did you invest the first few dollars that you saved? Did you not put this money in a savings bank? Were you influenced in doing so only by the fact that this is the safest form of investment? Were you influenced principally by the consideration that money in a savings bank may be withdrawn by you at any time, or were you also influenced by the fact that you could open an account in a savings bank for $10, or perhaps even less, while there was no other investment known to

you which could be purchased for so small an amount?

The $50 Liberty Bonds have served to place bonds within the purchasing power of everyone. Many worth-while securities are now offered in denominations of $500, $100 or $50. It has always been a principle of the House of Doherty to issue its securities in these smaller denominations, in order that they may be readily available for the small investor. This applies not only to stock, but also to the bonds of this House.

The denomination of an investment is a comparatively unimportant element, except in the case of the small investor; provision for the small investor has always been made by the House of Doherty by the issue of securities in small denominations.

Appreciation.

We have already seen that when you make an investment it is your intention to keep it and not to dispose of it unless you actually are in need of funds. If this is so, why are you interested in the appreciation of your investment? If the bond in which you have invested your money goes above par, you can reap advantage only if you sell it before it matures, and you have already stated that this is unlikely. Can you get more than one hundred cents on the dollar for it at maturity? If you cannot, the possible appreciation in the case of a bond is limited by the face value, which is the amount which will be repaid to you at maturity. In the case of a stock, the possible appreciation is unlimited.

What causes the appreciation of an investment? What causes a rise in the price of any commodity? A large demand for a commodity is the usual cause of a rise in the price. Such competitive demand for an investment is the usual cause of its appreciation. What causes this competitive demand? A recognition of its investment virtues generally results in a demand for an investment. The virtues most frequently recognized in this manner are security of principal, or comparatively large income return. Astuteness in the selection of an investment enables a person sometimes to recognize in advance such investment virtues. If you buy a bond at 80, and it is paid at maturity at par, is this true appreciation? Is it not rather a recovery from depreciation? Why does this pseudo-appreciation make discount bonds so attractive? Is it because on an investment purchased at a discount the investor believes he obtains a larger income return than the interest rate on his coupon? Is it because the investor believes he is increasing his principal by obtaining a hundred dollars at maturity for something for which he paid only $80 when he purchased it? If he increases his principal in this way, is it not done by sacrificing his income? Is true appreciation based on the net income or is it based on the purchase price or quotation?

True appreciation, resulting from a growth of competitive demand, due to a recognition of the virtues of an investment, must be differentiated from the pseudo-appreciation resulting from the

purchase of a discount bond where, through lack of proper amortization, the investor sacrifices income in his efforts to increase his principal.

Salesman's Function.

What practical use will you make as a salesman of these ten elements of an investment? Will you analyze each investment that you offer to your client into these ten elements? Few clients will give you the time to enter into such an exhaustive analysis. Such an exhaustive analysis you will find in most instances as unprofitable as it is unnecessary. Which element will you always emphasize? Unimpeachable security of principal, of course. What should always be coupled with unimpeachable security of principal? High income return. How high should this income return be? We have seen that a high income return is a cautionary signal. Your success as a securities salesman will be measured by your ability to furnish your clients with investments having a higher income return than those offered by the salesmen of other houses without in any way sacrificing the security of the principal back of your investments.

What use can you make of the other elements of an investment mentioned in this chapter? Do you think any investment possesses all of them to the highest degree? Is it not true that only by sacrificing some of the investment elements of minor importance can an investor secure an investment satisfactory from the point of view of the more important elements.

There is no such thing as an ideal investment. The skillful salesman uses the various elements of an investment which we have described in pointing out the desirable qualities of the investments which he is offering.

The true function of a securities salesman is to offer to his client an investment possessing unimpeachable security of principal, together with an income return considerably higher than would be the case if the qualities of the security were better known to the public.

Collateral Reading.

Each student is expected to read in the volume entitled, "The Principles of Bond Investment", by Lawrence Chamberlain, Chapters II and III. A copy of this book may be obtained from Henry Holt & Company, 19 West 44th Street, New York City, at a cost of $6.00. Copies may also be consulted in the public libraries in most cities throughout the United States.

QUESTIONS.

Note: No student will receive the third lesson of this correspondence course until he has submitted to the Educational Director a comprehensive satisfactory answer to each of the following questions. Typewritten answers are preferred. Answers should be addressed to Dr. L. F. Fuld, 60 Wall Street, New York City.

1. Is a trolley car real property or personal property? Is a railway trestle real

property or personal property? Give your reasons in full for your answer.

2. If you purchase one of the non-interest bearing lottery loan securities of the French Government, are you investing, speculating or gambling? Give detailed reasons for your answer.

3. Is the purchase of a stock always a speculation, and the purchase of a bond always an investment? Reasons for your answer.

4. Do you think most investors give more consideration to security of principal or to income return? Why?

5. Explain in your own words the difference between stability of income and income return.

6. Why is the collateral value of an investment so closely related to its maretability?

7. Is the element of care more important in the case of a small investor or in the case of a large investor? Give your reasons.

8. Under what circumstances are long term investments preferable to short term investments?

9. Do you consider denomination an important investment element? Give your reasons.

10. It is said that appreciation results from a recognition by the investor of the virtues of an investment. What elements of an investment are most likely to result in appreciation?

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